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C O N F I D E N T I A L SECTION 01 OF 02 SOFIA 000127

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TAGS: ECON EFIN PREL PGOV BU
SUBJECT: BULGARIA: THE ECONOMY'S MUDDLING THROUGH, BUT THE ELECTORATE WANTS MORE

REF: STATE 23758

Classified By: Ambassador Nancy McEldowney for reasons 1.4 (b) and (d).

¶1. (C) Summary: Bulgaria is finally feeling the effects of the global financial crisis. After years of impressive growth, major indicators are down and the real economy is taking a hit. But years of fiscal conservatism have left Bulgaria with sufficient buffers to avoid the financial turbulence seen in many of its neighbors, at least for now. Despite the country's relatively strong position, Prime Minister Sergey Stanishev is struggling to benefit from his government's prudent management of the economy. Facing an uphill re-election campaign, Stanishev is increasingly hammering his main rival, Sofia Mayor Boyko Borrisov, on economic issues. If this effort fails to impress a Bulgarian public that has become used to gangbuster economic growth, we may see Stanishev resort to other tactics, including bashing the EU for perceived double standards and lackluster support of Bulgaria during hard financial times. End Summary.

¶2. (C) The global contagion has finally hit Bulgaria. After five years of impressive GDP growth (averaging seven percent annually), foreign direct investment and remittances are down, tourism revenues are sagging, key industries are in major contraction, the real estate and construction sectors are easing up, exports are shrinking and unemployment is creeping higher. Still, Bulgaria is muddling through. In contrast to many East European neighbors, Bulgaria entered the crisis in relatively strong shape. A policy of fiscal conservatism translated into consecutive years of budget surpluses and left the country with healthy buffers. The currency board, the bedrock of Bulgarian financial stability since a catastrophic banking crisis in 1997, remains strong.

¶3. (C) While growth is taking a hit, experts still expect GDP in the positive range, perhaps 1-2 percent for 2009. Privately, some in the government are bracing for negative growth by year's end, but know that much will depend on the economies of other key countries, first and foremost Germany. An EBRD team that just visited Bulgaria had a cautiously positive outlook. On March 17, the IMF deemed Bulgaria's banks "still well-capitalized, liquid and highly profitable." Though the IMF warned of problems, including a possible recession, wage-driven inflation and falling competitiveness, it was basically a soberly positive assessment. Although the mostly-foreign owned banking sector has tightened lending significantly, these banks are comparatively less concerned about Bulgaria than about investments and loans in other East European countries. At a recent AmCham meeting, most firms were guardedly positive.

¶4. (C) Try as the government might, PM Sergey Stanishev and his Socialist-led coalition can't seem to benefit from this

relative stability. As they prepare for summer elections, the Socialists are facing the hard reality that the Bulgarian electorate has become accustomed to some of the highest rates of growth in Europe and anything less just won't do. Moreover, there is the phenomenon of "the two Bulgarias" -- one centered on booming Sofia and a few other cities and certain sectors (especially IT) and the other rural, poor, and fast losing population. Some analysts predict that economic contraction will hit Bulgaria first in the real economy and then spread to the financial sector, a reversal of what has transpired elsewhere. Bulgaria's over-sized grey economy (estimated to be as high as 30 percent) is a cushioning factor of sorts, but cannot absorb shocks.

¶5. (C) While the macroeconomic indicators are not dire (at least not yet), the political indicators are sliding to danger zones. Stanishev is struggling to plead his case at home and abroad: his government's fiscally-conservative policies, while often criticized by the leftist wing of his own party, have allowed Bulgaria to avoid the financial dislocations that have plagued many of Bulgaria's neighbors. With an eye on the economy -- and the elections -- Stanishev loosened the purse strings in the 2009 budget somewhat, including both an increase in pensions and a stimulus plan (referred to here as Stanishev's "Obama Plan"), but still targeting a two percent surplus. The public was not impressed.

¶6. (C) On the international stage, Stanishev and his government have fiercely argued for greater differentiation among the situations of East European countries. He has

pushed for speedy acceptance to ERM-II, to put Bulgaria on a clear path to Eurozone membership. The government has pursued greater cooperation with the IFI's, with the EBRD's March 17 announcement of a 250 million euro investment in Bulgaria's energy sector the latest example. At the same time, Stanishev has ruled out any discussion about the need for an IMF precautionary agreement, saying such a deal is not only unnecessary, but potentially harmful, as it would undermine the investor confidence that Bulgaria has worked so hard to build.

¶7. (C) Despite the Stanishev government's obvious economic credentials, the Socialists continue to lose ground in the polls to their main rival, GERB, the party of Sofia Mayor Boyko Borrisov. As elections approach, we can expect the government to continue to call attention to GERB's flimsy economic platform and thin economic bench. If these arguments fall on deaf ears and the Socialists continue to struggle, Stanishev and his government may resort to another well-worn strategy: blame the foreigners. The EU will come in for particular criticism. While Stanishev himself is a committed Europeanist, he has been stung by successive negative EU monitoring reports on Bulgaria's rule of law performance. His bitterness was visible after the EU's November announcement of the permanent loss of over 220 million euros in pre-accession funding. His government has been increasingly vocal over what it insists is an anti-Bulgaria double standard in the EU and in European media: on rule of law issues, Eurozone membership, financial support for energy infrastructure projects after the January gas cut off, and the EU-mandated closure of two Bulgarian nuclear reactors.

Comment

¶8. (C) Running on his economic credentials will likely not pay off for Stanishev. The Bulgarian electorate has pocketed the gains made leading up to Bulgaria's 2007 EU accession and now voters are clamoring for more. The Socialist-led government basically starved major social investments (the health care, educational, and transportation infrastructure here is dismal) and kept a pretty tight lid (until recently)

on public sector wages. With foreign direct investment down, speculative real estate growth fast contracting, and loose lending drying up, the easy days of growth and personal wealth gains are over. An economy that is seen as just "muddling through" after years of gangbuster growth is unlikely to impress the average voter, even as Bulgaria's neighbors are falling victim to financial turbulence.

¶9. (C) The government is testing a risky tactic. If Bulgaria experiences a true economic crisis in the next several months, including bank failures, the electorate may decide to go with a tried, tested and known leader -- the intellectual Stanishev -- over the brash, unpredictable, "tough guy" Borrisov. It's a long-shot, but part of the ruling Socialists' gameplan. Bulgaria is now on the outer edge of world financial turbulence, but this small economy (Walmart's annual revenues are more than eight times Bulgarian GDP) could easily get sucked into the vortex. The Socialists could come out ahead in this case, but unfortunately for Stanishev, such a gain would have to be precipitated by a loss of economic stability. It is much more probable that such economic problems will fuel massive public anger at -- and rejection of -- the governing parties. Whatever the state of the economy, the election campaign will be nasty, and investors will likely wait to gain clarity and predictability under a new government before venturing on many new projects.
McEldowney